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ABSTRACT

This booklet is intended to help trustees of institutions of higher education understand the relationships among tuition, financial aid, and enrollment. It suggests questions trustees can ask of administrators and recommends the data needed to make informed decisions. Advocates and critics of higher education increasingly demand that colleges and universities reveal more about price, cost, and subsidy so that students and parents can make informed decisions. Boards should make certain that their institutions provide the clearest and most accurate information about cost structure to all applicants. Most trustees should understand the demand curve and should consider the institution's standing compared with similar institutions. Regardless of the comparison, an institution will find that allowing tuition to increase faster than most applicants' ability to pay is self-defeating. Either the institution will have to limit the size of the applicant pool and be less selective, or it will have to increase its financial aid budget to make tuition less affordable. Setting tuition is central to nearly every aspect of an institution, with enormous impact on the institution's fiscal health and vitality. (SLD)



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ED 457 770

BOARD BASICS

FINANCIAL MATTERS

# SETTING TUITION

BY WILLIAM S. REED

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ASSOCIATION OF GOVERNING BOARDS OF UNIVERSITIES AND COLLEGES

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## William S. Reed

Will Reed's career spans 40 years in academic institutions and nonprofit organizations. He has been a chief financial officer, a chief development officer, and a chief human resources officer. He also has served as an administrative officer of a foundation and a government contracts officer.

Reed began his career in 1961 with the U.S. Atomic Energy Commission, where he negotiated contracts with major research universities. In 1967, he moved to the Ford Foundation as an administrative officer in India and later in New York. He was director of personnel for Princeton University from 1973–77. He then moved to Kenyon College, where he served as vice president of development from 1977–80, and then to Williams College, where he was vice president for administration and treasurer and secretary of the board, until 1993. Reed was the vice president of finance and administration at Wellesley College until 2000. He currently serves as Wellesley's vice president of the college.

Reed received his undergraduate degree from Kenyon College and his masters of public administration at the Maxwell School of Public Affairs at Syracuse University. Reed is a frequent contributor to professional publications and has conducted numerous seminars on financial issues for AGB and NACUBO.

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# SETTING TUITION

Deciding how much to charge for the institution's "product" ultimately is the responsibility of the board. Few other board decisions affect so many, are watched so closely, and are so vulnerable to comment and criticism. Over time, few other decisions so cumulatively and profoundly shape the institution. Setting tuition and fees goes right to the heart of the institution's reputation for affordability and accessibility.

Setting tuition can be easy or complicated. It's easy when the board adopts a simple formula, such as: "Tuition will increase at the rate of growth in the Consumer Price Index (CPI) plus 1 percent," and then monitors its growth in relation to the tuition rate at peer institutions.

This pricing policy becomes complicated, however, when the board closely examines its implications and consequences. Board members should ask: Does our pricing help or hurt in attracting the type of students we want to enroll? How many students actually pay the full published price? Do we use financial aid strategically to recruit a freshman class with certain characteristics, or do we use it to attract the greatest number of students? Is our price competitive? What is our net tuition after financial aid? How dependent are we on tuition revenue?

This booklet is intended to help trustees understand the relationships among tuition, financial aid, and enrollment. It suggests questions trustees can ask of administrators and recommends what data are needed to make informed decisions.

## The Board's Responsibilities

The increase in the price of a college degree has become one of today's most heated social and political issues. Countless editorials and feature articles lament the escalating cost of an undergraduate education. The perception of many is that tuition is too high and students are not receiving fair value in return. Higher education is depicted as profligate and aloof.

Boards of independent institutions are responsible for being stewards of the public trust *and* for ensuring their institutions have sufficient resources to carry out their missions. Balancing these competing needs, of course, is difficult. It requires an informed and strategic pricing strategy. It requires trustees to understand how price influences the institution's attractiveness to students and the type of students the institution seeks to enroll. In the end, setting tuition is a complicated calculus that must account for philosophical and financial variables.

## Tuition Basics

The published price of a college or university education usually is divided into three parts:

- ***Tuition and Fees.*** At most private institutions, tuition covers students' costs to enroll in four or five courses per semester or quarter. Some colleges charge by the course or course hour, especially those that have a high percentage of part-time students. Mandatory fees vary among institutions and cover a wide range of activities—student-health charges, use of athletic facilities, student activities, use of laboratories, and so on.

- ***Room and Board.*** Colleges charge residential students a separate fee for housing. Generally, these fees are billed by semester or quarter and include all utilities, except telephone. Few schools charge extra for Internet access. Room rates sometimes depend on whether the room is a single, double, or part of a suite. Students typically choose from a variety of meal plans.

- ***Books, Travel, and Living Expenses.*** Tuition, fees, and room and board constitute the institution's "comprehensive fee." To determine the total cost of attendance, colleges also take into account books, travel, and everyday living expenses.

The total student expense budget is a critical number in calculating the amount of financial aid for which a student might qualify at those institutions that award financial aid on a need basis.

| Total Student Expense Budget | |
|---|---|
| Tuition | $20,000 |
| Fees | $2,000 |
| *Subtotal* | $22,000 |
| Room | $3,400 |
| Board | $3,300 |
| *Subtotal* | $6,700 |
| *Subtotal, comprehensive fee* | $28,700 |
| Books, miscellaneous expenses | $2,000 |
| ***Total*** | **$30,700** |

**How Tuitions Are Set.** The tuition-setting processes at private institutions tend to follow similar paths. First, finance officers compare the current tuition at their institution with that at peer institutions. Comparisons are made on current and historical data, not on what institutions plan to do. (Some years back, college administrators freely exchanged information about planned tuition increases, but the U.S. Department of Justice determined that such practices constituted price fixing and were illegal.)

Next, officials analyze the rate of increase in the Consumer Price Index (tuition increases often are reported by the media in relation to the CPI). Consequently, many schools index their increases to the CPI. Although quite common, this practice is not financially sound because it does not reflect the market value of goods and services colleges use.

A better index is the Higher Education Price Index (HEPI), though members of the media and the general public generally are unfamiliar with it. Faculty and staff compensation constitute 75 percent of the HEPI. Compensation typically accounts for 60 percent to 80 percent of the cost of running education institutions. Annual increases in the HEPI have been greater than those in the CPI since the early 1980s. Before that, the CPI grew faster than the HEPI because faculty and staff salaries did not keep pace with inflation.

Another key statistic used as a benchmark for setting tuition is the growth in disposable income, which is a good proxy for the amount of money families have for expenses such as higher education. If tuition increases faster than the disposable income available to the population from which the college attracts students, the college eventually will price itself out of the market. A simple graph showing the real growth (after inflation) in tuition and the real growth in disposable income over a ten-year period can be extremely useful for assessing tuition trends at your institution.

**Bottom Up Versus Top Down.** At the risk of oversimplifying the long and arduous process of building an annual operating budget, the amount of revenue needed to balance a budget can influence the size of the tuition increase. This "bottom-up approach" involves developing the expense budget first and then examining revenue. After expenses are established, the sources of revenues are estimated—gifts, endowment support, sponsored research, and other miscellaneous income. The remaining item is tuition, the largest revenue contributor in private institutions, which then closes the gap.

This process falsely assumes that price will not affect enrollment. Few institutions build their operating budgets using the bottom-up approach because tuition increases are affected by many factors other than the size of potential budget deficits. Thus, a top-down approach helps prevent the practice of backing into tuition increases and encourages a slower rate of tuition growth.

**Pricing Strategies.** Colleges employ a variety of pricing strategies. One strategy that dominated higher education for several years is called the "high-tuition, high-aid" approach. This strategy assumes that parents and students equate price with quality. It has two significant drawbacks.

First, college leaders no longer can justify tuition increases that greatly exceed the rate of inflation. Second, many colleges have difficulty finding enough academically capable students whose families are able to pay high tuition. This condition leads to under-enrollment and results in a greater percentage of students who require financial aid.

"Low-tuition, low-aid," obviously, is the opposite strategy. It is based on the assumption that "best bargain" is more attractive to students than "highest quality."

REGARDLESS OF THE SPECIFIC STRATEGY USED BY AN INSTITUTION, AN OFTEN-HEARD COMMENT AT TUITION-SETTING TIME IS "DON'T LEAVE MONEY ON THE TABLE."

The most common approach to setting tuition is to remain competitive within your peer group. Some college leaders believe their institution can be the price leader of their peer group; others pride themselves on being the least expensive; most try to fall in the middle third. This strategy explains, in part, why tuition charges among peer institutions are relatively similar.

Regardless of the specific strategy used by an institution, an often-heard comment at tuition-setting time is "don't leave money on the table." Such a comment may sound cynical to those unfamiliar with the difficulty of balancing an operating budget. However, academic institutions simply cannot afford to set tuition below a level the applicant pool is able and willing to pay. The needs are simply too great.

Here's how the process works: The administration recommends a tuition increase to the board after a lengthy process that includes considering how the institution compares with peer institutions, the competitive position to which the institution aspires, budget pressures, the rate of inflation, and the estimated amount of disposable income available to tuition-paying families. In the final analysis, a tuition hike is a business judgment—as much art as science. Following a tuition announcement, finance officers hope they and the board made the right decision, but only final enrollments tell the story.

Setting tuition is a crucial decision, one dependent on many variables. The reality is that only a fraction of students pay the published price. Nevertheless, the published price is important because it sets the boundaries for tuition discounting and determines the general subsidy all students receive.

THE PRESSURE TO INCREASE FINANCIAL AID IS UNRELENTING BECAUSE "BUYING" QUALITY AND DIVERSITY IN THE STUDENT MIX REQUIRES MONEY.

FINANCIAL AID AND TUITION DISCOUNTING. All institutions want to attract gifted students. High-quality students attract other high-quality students, and this helps the institution recruit outstanding faculty, which in turn improves the institution's academic reputation. Improving the ranking and prestige of an institution is a never-ending process. Because there are too few highly able students to go around, many schools use pricing policies and financial-aid awards strategically to attract their share of such students. It is tricky work.

Administering financial aid is anything but simple or straightforward. The first decision financial-aid administrators must make with their boards is how much financial aid the institution can afford to provide. Only a handful of institutions can afford to sustain totally need-blind admissions policies. Such policies allow institutions to admit students without regard to their ability to pay by providing all the scholarship and grant money required to ensure that all accepted students are able to attend.

The vast majority of colleges and universities are forced by circumstances to limit the financial aid they can offer promising-but-needy students. They simply do not have the financial underpinnings that permit need-blind policies. For institutions with small endowments, financial officers must calculate annually the amount of financial aid the institution can afford.

This is serious business, and the stakes are high. The pressure to increase financial aid is unrelenting because "buying" quality and diversity in the student mix requires money. Financial aid typically is one of the fastest growing areas of academic budgets. Given the need to restrict financial-aid funds, colleges must decide how best to spend these limited resources. A variety of approaches exist. But an institution first must resolve a fundamental policy question: Should financial-aid awards be based on student need? If the answer is Yes, then the second question: How will need be determined?

An institution may take another approach and decide that a better use of its limited financial-aid budget is to award scholarships based on academic merit rather than need. This strategy can be useful in attracting a critical mass of high-ability students, but this may occur at the expense of underenrolling an entering class.

THE FEDERAL METHOD. If a college or university receives federal funds for financial aid, it operates with some constraints on how it calculates need. But the law is somewhat flexible and provides room for professional judgment. Most colleges and universities use the federal method to compute students' need for financial aid.

The federal method is based on a family's adjusted gross income and the number of family members who are college students. It is fairly generous, but it does not account for the equity a family may have in other assets. Many institutions adjust the federal method to add home equity and savings to the adjusted gross income.

Finance and financial-aid officers must be experts on tax issues, understand the intricacies of a balance sheet, and know how to determine the worth of a small business—all while dealing with parents who may disagree about what they can or cannot afford. A financial-aid officer must exercise a great deal of judgment to determine the level of aid to which a student is entitled.

Once the level of need is determined, the officer compiles a financial-aid package, which includes a component called "student self-help"—summer and academic-year employment and federally funded student loans. Students are expected to earn a prescribed amount over the summer and during the academic year. While on campus, they may be employed for up to 20 hours a week in a federally funded work-study program, which is designed to provide employment opportunities for

students receiving financial aid. Students also may choose to work in a regular campus job, such as in food service or in the library. The amount students are required to earn as part of their financial-aid package increases each school year. A senior usually is expected to earn more than a freshman.

LIMITING FINANCIAL AID. Institutions can have a need-blind admissions policy but still not meet every student's financial need. In fact, this is quite common. The practice is called the "need aware" policy. A number of options exist for awarding financial aid on a "need aware" basis:

- *Deny/Deny.* In this situation, a student who is aid-eligible but not considered exceptional enough to receive a financial-aid award is denied admission. Institutional officials reason that such students will continue requesting financial aid, or they will have to assume such significant financial burdens that their educational experience will be compromised.

- *Admit/Deny.* In this situation, a marginally qualified student who needs financial aid is accepted but denied financial aid. If the student can figure out a way to pay the tuition, he or she will enroll.

- *Admit/Gap.* This practice admits a qualified student but meets only a portion (or gap) of his or her financial aid. It's up to the student to fund the difference.

- *Differential Packaging.* In these cases, financial-aid officers award students with similar financial-aid needs different aid packages. The more attractive the student, the better the package. For example, one student may receive a larger scholarship and a lesser loan burden, while another receives work-study and a loan.

- *Match Competing Offers.* Many students and parents try to leverage a higher financial-aid package from one college to persuade another college to make a better offer. If the student is highly desirable, the higher award might be matched.

- *Merit Awards.* This is an extreme form of differential packaging. The most desired students receive scholarships even though they may be ineligible for aid. College officials use this strategy to enroll a greater number of high-ability students at the expense of less able or needy students.

IN THE BEST OF ALL WORLDS, FINANCIAL AID WOULD NOT BE LIMITED, AND AWARDING IT WOULD BE A SIMPLE PROCESS.

- ***Need-Aware Second Review.*** Students who are placed on waiting lists subsequently are admitted based on their ability to pay. Aid-eligible students ordinarily are not considered in the second review.

- ***Modify the Methodology for Calculating Need.*** The method for calculating need can be changed to make it more flexible. For example, an institution that includes home equity as an asset for student-aid purposes might eliminate it or limit it after a certain threshold is met. The amount of need a student would qualify for can be increased or decreased by changing the methodology.

In the best of all worlds, financial aid would not be limited, and awarding it would be a simple process. Students who need financial aid would receive it. But most colleges and universities function with limited resources. Their challenge is to use a limited financial-aid budget strategically to leverage it. To that end, it helps to understand the concept of the "demand curve" to meet enrollment targets and ultimately shape an incoming class.

THE DEMAND CURVE. A demand curve is best explained by using the analogy of airline-ticket prices. On any flight from Boston to Seattle, passengers may pay different prices for the same kind of seat on the same flight. For those traveling on business, the ticket price may be irrelevant. For tourists and others traveling for pleasure, however, a special price may tip the scale in favor of buying the ticket. The airline wants to fill seats, so it will discount the price to attract enough customers to make the flight to Seattle profitable.

Similarly, colleges want full enrollment. They don't want empty beds and/or classrooms. The difference: Airlines don't particularly care about who their customers are, but colleges do. Colleges want to fill their dorms and classrooms with the most academically capable and well-rounded students they can attract.

To maximize the return on financial-aid grants, finance officers would like to know each student's position on the demand curve. Armed with such knowledge, they would be able to award financial aid perfectly—just enough to enable the student to enroll and not a penny extra that could be used to help another student enroll. While this perfection is nearly impossible to achieve, consulting firms with sophisticated technical skills have emerged to help institutions assess their demand curves.

Finance and financial-aid officers must make these judgments when they deviate from using a consistent methodology to award financial aid. This condition is prompted by "fax wars," which occur after colleges have mailed acceptance letters and have communicated financial-aid awards to students. If a student receives a higher financial-aid offer from a competing institution, he or she often will fax that offer to an institution offering less. Then negotiations begin. Institutional officers must make judgments on the spot, balancing how much the school wants the student and to what degree additional financial-aid might persuade the student to enroll. In other words, where is that particular student on the demand curve? It is a very intense time for all involved.

TUITION DISCOUNTING. Boards must consider two key questions regarding tuition and student subsidies: What is the right level of financial aid? What is the relevance of the published price? In other words: What is our student discount rate?

Not long ago, all students were assumed to pay full tuition, and the financial-aid budget (from restricted and unrestricted sources) was calculated as an operating expense. In 1996, the American Institute of Certified Public Accountants (AICPA) audit and accounting guide was revised and included a new guideline for the display of tuition discounting at private institutions. The AICPA concluded that financial aid was a *discount* from the published price and not an operating expense. Under the revised guidelines, private higher education institutions are required to discount tuition revenue by the amount of institutionally funded financial aid. (The Government Accounting Standards Board imposes a similar requirement on public institutions.) Thus, financial aid no longer is treated as an expense on the debit side of the ledger. "Statements of activities" (which all private institutions must report) now display gross and net tuition. For example, a typical statement of activities shows net tuition and then subtracts university-sponsored financial aid and donor-sponsored financial aid to derive a net financial figure.

Highly selective colleges and universities argue that financial aid is an expense and not a discount because they can fill their classes with high-ability, full-tuition-paying students if they so choose. These institutions do not award financial aid to increase overall revenue; rather, they do so to attract specific kinds of students. Therefore, argue highly selective institutions, financial aid is a legitimate educational expense.

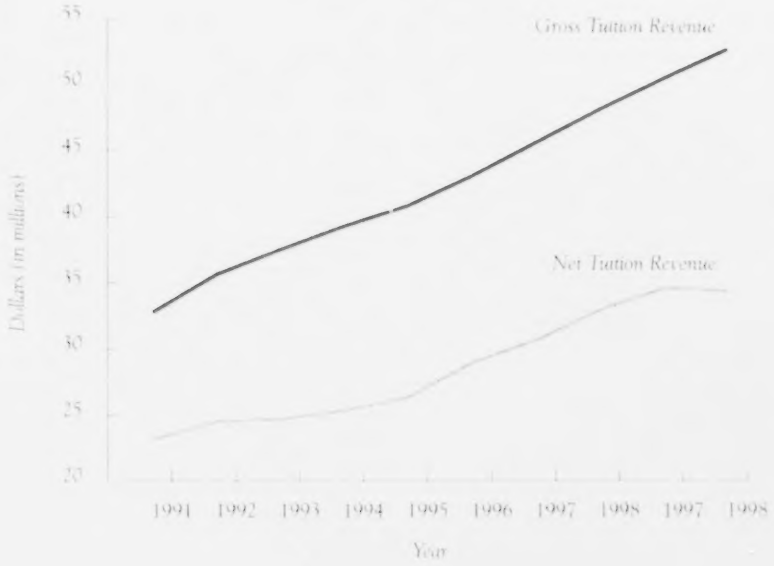
Only a handful of colleges and universities fall into this category, however. Most private colleges rely on financial aid to meet enrollment targets. For these colleges, awarding financial aid increases revenues. Given the high fixed costs of running a college, the marginal cost of enrolling an additional student is relatively low. If students are added above the enrollment target, however, the marginal cost can be significant because additional faculty and space may be required to serve the student. In the world of enrollment management, most schools use financial aid to meet enrollment targets and improve the quality and diversity of their student body.

For most of higher education, net tuition is increasing at a slower rate than gross tuition. The reason: Financial-aid costs (the tuition discount) increase faster than the published price of tuition. The published price tends to increase at a fairly predictable rate, while net tuition increases somewhat erratically. The leveling off of net tuition, or its actual decline in some cases, is a serious issue for many colleges.

Net tuition is what you take to the bank. A college must expect to accumulate a specific amount of net tuition to balance the budget. Officials should monitor the relationships among the published tuition price, financial aid, net tuition, and the true cost to educate a student. The board should ensure that the administration can answer two basic questions: (1) What is the effect of the published tuition price on financial aid and net tuition revenues? (2) To what extent must the published price increase yield a targeted level of net tuition? Trustees also should keep their eyes on the institution's "total discount rate." It is important to be concerned about trend lines.

Answering these questions requires a fairly complicated tuition-discounting model. However, finance officers also should be able to construct a simple graph displaying the relationship between gross and net tuition to help trustees monitor trends in this crucial area.

## Net and Gross Tuition Revenue




**Price, Cost, and Subsidy.** It is important for trustees and the general public to understand the differences among price, cost, and general subsidy. Observers agree that all students actually receive some form of subsidy and that tuition covers only a fraction of the true cost to educate a student. *In fact, all students receive a subsidy even when they pay full tuition.* This makes higher education an extraordinary value.

Knowing the size of an institution's subsidy is important, but it is not an easy calculation. Most institutions have cross-subsidies, and this makes the calculation more complicated. A simple way to calculate an institution's subsidy is to divide the cost of education (total expense) by the number of students. This yields the "average cost per student." Subtracting the published price (tuition) from the average cost produces the subsidy. The simple formula is "subsidy equals cost minus price."

The problem with this approach is that it does not address what economists call the "joint products" problem. For many institutions, the costs incurred are simultaneously supporting several different institutional goals and products, which can include undergraduate and graduate education, student and faculty research, and public service. The classic example of a cost that cannot be easily divided up is the library. For institutions with a mission broader than undergraduate teaching, allocating library costs to determine the true cost of educating an undergraduate takes some work.

In 1998, the National Association of College and University Business Officers assembled a group of finance officers from all sectors of higher education in the hope that a common methodology could be fashioned to determine the size of subsidy for a vast array of higher education institutions. The goal was to develop a methodology that would be accurate enough to be useful and simple enough to be calculated and widely understood. This proved to be a difficult undertaking, and in 2001 the group was still working to refine a methodology that would be relevant for all sectors of higher education.

The reason this issue is so important is that the public does not appreciate what it costs to educate a student. And there is a debate on whether a high subsidy should be a matter of pride or embarrassment. For a student, a high subsidy surely is a good thing—that is, receiving a $30,000 education (cost) for $15,000 (price). For an institution, it could be viewed as poor fiscal management.

Boards should know the size of the subsidy, how it changes over time, the relationship between subsidy and tuition, and the true cost of educating a student. Regardless of an institution's specific data about costs, all trustees must keep in mind that setting tuition requires tradeoffs among quality, price, subsidy, and mission.

## Responsibilities of Individual Trustees

What broader information do trustees need to make informed decisions about tuition? Clearly, they must rely on the financial-aid officer and the chief finance officer to recommend a pricing strategy. In addition, they must understand the following information and resulting trends to meet their fiduciary responsibilities:

- How does tuition at our institution compare with tuition at our peer institutions?
- How does the rate of tuition growth compare with the Consumer Price Index and the likely disposable income of our applicant pool?
- What is the difference between gross tuition and net tuition?
- What are the trends for price, cost, and subsidy for the last five years?

- What percentage of students receive financial aid?
- What is the average financial-aid grant?
- What methods do we use to award and control financial aid?
- How does the academic performance of our full-financial-aid students compare with that of full-paying students?
- What are the loan and work expectations of financial-aid students?

## Conclusion

Advocates and critics of higher education increasingly demand that colleges and universities reveal more about price, cost, and subsidy so that students and parents can make informed decisions. The 1998 National Commission on the Cost of Higher Education found that "college finances are far too opaque. Higher education has a major responsibility to make its cost and price structures much more 'transparent'... [and] easily understandable to the public and its representatives."

Boards should make certain their institutions provide the clearest and most accurate information about cost structure to all applicants. It bears repeating that trustees should understand the demand curve. Every institution has admitted applicants who chose not to attend. Where did they enroll instead? If they enrolled in less expensive institutions, price may have been a deciding factor. If they enrolled in equally expensive institutions, then perceived quality may have been an issue.

Regardless of an institution's standing compared with its peers, it will find that allowing tuition to increase faster than most applicants' ability to pay is self-defeating. Either the institution will have to limit the size of the applicant pool and be less selective, or it will have to increase its financial-aid budget to make tuition affordable.

Establishing the policies that determine tuition and the amount of subsidy each student will receive ultimately is the board's responsibility. Setting tuition is central to nearly every aspect of an institution, including its mission, the size and quality of the student body and faculty, perceived quality, affordability, and accessibility. In the end, it is a judgment call, but its impact on the institution's fiscal health and vitality is enormous.

## Resources

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BOARD BASICS

This publication is part of **Board Basics**, an AGB series devoted to strengthening the effectiveness of governing boards and trustees. Board Basics comprises several topic clusters—The Fundamentals, Financial Matters, Fund-Raising, Academic Affairs, Foundation Relations, Leadership, Strategic Decisions, and Effective Committees—each of which contains several booklets. Several assumptions underlie the series:

- Academic trusteeship grows increasingly ambiguous, and trustees need concise, accessible, and focused information to help them carry out their complex fiduciary and stewardship responsibilities.
- Basic principles of trusteeship remain constant across higher education, regardless of institutional type, size, and mission. The series highlights these general principles to provide trustees with a core of knowledge they can apply to their individual institutions.
- The series addresses the distinguishing characteristics of academic trusteeship, especially as it differs in scope, substance, and focus from corporate directorships and other board service.

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